APPENDIX I

[¶ 61,101]

Middle South Services, Inc., Docket No. ER 79-277

Opinion No. 124; Opinion and Order Affirming in Part and Modifying in Part Initial Decision

(Issued July 30, 1981)

Before Commissioners: C. M. Butler III, Chairman; Matthew Holden, Jr., and J. David Hughes.

[Note: Initial Decision issued November 13, 1980 appears at 13 FERC ¶ 63,032.]

Appearances

Richard M. Merriman, Robert S. Waters and *Lisa H. Powell* for Middle South Service, Inc.

Robert C. McDiarmid, Frances Francis and *J. Mark Davis* for Arkansas Attorney General.

N. M. Morton, Jr. for Arkansas Public Service Commission

Michael R. Fontham for Louisiana Public Service Commission

Robert L. Woods and *L. Jorn Dakin* for Staff, Federal Energy Regulatory Commission

[Opinion No. 124 Text]

Since 1973 Middle South Services, Inc. (MSS) and the four electric utility subsidiaries of Middle South Utilities, Inc. (MSU) [1] have been operating pursuant to an interconnection agreement (System Agreement) under which the operating utilities exchange power and energy on a pool basis. Certain categories of expenses under the System Agreement are subject to automatic adjustment clauses. This proceeding involves a proposal by MSS to expand the categories of expenses subject to the automatic adjustment formulae and to increase the rate of return under the Agreement.

An initial decision was issued in this docket on November 13, 1980. Briefs on and opposing exceptions to the decision were filed by the Louisiana Public Service Commission (Louisiana), MSS and the Commission staff.

We affirm and adopt the initial decision on all issues except automatic adjustment clauses, rate of return, and accumulated deferred taxes.

1/ MSU, a public utility holding company, owns all of the common stock in MSS and the four utilities:Louisiana Power & Light Company, Arkansas Power & Light Company, Mississippi Power & Light Company, and New Orleans Public Service Inc. (At the time the case was filed, MSU owned a fifth utility subsidiary, Arkansas-Missouri Power Company. That subsidiary has since been merged into Arkansas Power & Light Company.) MSS acts as an agent for the MSU subsidiaries in various regulatory matters.

Section 3.01 of the System Agreement under which the MSU subsidiaries exchange power provides a basis for equalizing among the companies any inbalance of costs associated with the construction, ownership and operation of such facilities as are used for the benefit of all the companies. Charges are made under five separate service schedules: (1) capability equalization, (2) transmission equalization, (3) exchange of electric energy, (4) distribution of revenue from sales made for the joint account of all the companies, and (5) distribution of operating expenses of the system operations center. The issues in this proceeding focus on capability and transmission equalization service schedules.

The agreement requires each MSU operating company to have generating capacity and other facilities necessary to supply its own customer requirements. However, the Operating Committee, which is composed of members designated by each of the subsidiaries and the parent company, may also require an individual company to construct, own and operate a new generating unit of sufficient size to achieve economies of scale and help provide capacity for the projected system load. Such a new participation unit ultimately will be needed to meet the native load requirement of the individual operating company, but until the time that company's load growth can absorb the total capacity of the new plant, its output and associated costs are shared by the other subsidiaries according to their respective capability responsibilities as defined in the Agreement.[2]

2/ Section 2.13 of the Agreement defines capability responsibility as system capability multiplied by the responsibility ratio for a company. The responsibility ratio is obtained by dividing a company's load responsibility by the system load responsibility.

Operating companies which own generating capacity less than their capability responsibility ("short" or "buying" companies) are required to pay a capability equalization charge to companies owning generating capacity in excess of their responsibility ("long" or "selling" companies). Equalization payments reflecting the capacity costs of the participation unit are made on a monthly basis. When a new participation unit is installed or when there is a change in investment in an existing participation unit, charges under the Agreement are automatically adjusted to reflect changes in investment and capital costs. Transmission costs are equalized in a similar manner.

Although the service schedules at issue in this proceeding govern the amounts paid and received among the operating companies as a result of the interchange transaction, those payments are accounted for in wholesale and retail regulatory proceedings, primarily at the state level. Payments received by a selling company under the service schedules are treated as revenues in that company's state regulatory proceedings, and may serve to offset the total revenues which the ratepayers in the state must advance to achieve the rate of return permitted in that particular jurisdiction. Likewise, payments made by buying companies are treated as expenses in the buying company's state jurisdiction, and may act to increase the total revenues that state's ratepayers must contribute to provide the rate of return allowed in their jurisdiction.

Automatic Adjustment Clauses

The above described interconnection agreement between the MSU operating subsidiaries contains both capability and transmission cost equalization formulae by which operating companies having excess generating or transmission capacity sell the excess to companies having deficient capacity.

Under the previously approved formulae, operation and maintenance costs, general and administrative overheads attributable to the production function, return on common equity, and the capital structure ratios were fixed, while other components were adjusted automatically as their values increased or decreased. In this proceeding MSS seeks to place operation, maintenance, and general and administrative expenses under automatic adjustment formulae. This would make all costs, except cost of equity, subject to the automatic adjustment clauses. [3]

The presiding judge determined that MSS had not shown "good cause," pursuant to Section 205(d) of the Federal Power Act, [4] to totally exempt it from making a filing with the Commission when changes are made either to the components of the formulae or the numbers which comprise the components. He concluded that MSS should be able to change the numbers in the proposed formulae without having to make a Section 205 filing each time a number is changed, but that it should file an annual report with the Commission, subject to certain requirements set forth at pages 18 and 19 of his decision.

Exceptions to the judge's decision were filed by MSS and

3/ The categories of costs proposed to be recovered through the equalization formulae are: (1) rate of return, (2) depreciation, (3) insurance premiums, (4) taxes, and (5) operation, maintenance, administrative and general expenses. The rate of return would remain fixed.

4/ Section 205(d) provides that the Commission, for good cause shown, may allow rate changes to take effect without requiring the usual statutory 60-day notice requirement.

the Commission staff.[5] MSS objects to the judge's first three reporting requirements because they are designed to apply to all components of the pricing formulae, not just the proposed OM component (which would consist of operation and maintenance and general and administrative overhead expenses). In support of its argument that refund conditions should be restricted to the proposed OM component, MSS states that the other automatic adjusting components, except rate of return on equity, were already approved by the Commission in 1973, and that they are actual recorded costs which are routinely subject to audit by independent outside auditors, local regulatory auditors and the Commission's own audit staff MSS believes any further inquiry into such costs is duplicative and unnecessary.

MSS also claims that the judge's proposal might be construed as requiring that *all* charges collected during certain months would be collected subject to refund, not just those additional revenues resulting from changes in the pricing components. Such a requirement, states MSS, is clearly contrary to Section 205 of the Federal Power Act. MSS would agree to a refund condition which applies only to any additional revenues collected under the proposed OM component during the year succeeding each annual change in the component, as opposed to the potential refund obligation the judge would impose on all revenues collected for the preceding year. It would agree to provide data to support an upcoming change on or before March 31 of each year and then implement the change on June 1. If an investigation

5/ Although Louisiana originally argued that proper resolution of this issue would be to establish a fixed rate which could be changed by MSS only in a Section 205 proceeding, Louisiana did not except to the judge's decision.

were instituted, only the increased revenues collected after June 1 would be subject to refund.

The staff believes the initial decision must be modified either to approve the proposed formulae as the rate, without any review procedure, or, in the alternative, to allow approval of the formulae for a limited term with annual review of the increased charges resulting from operation of the formulae.

It is the staff's first position that the proposed changes to MSS' existing formulae should be allowed *in toto*, without any attached conditions. Staff bases this position on the *Central Power and Light Co.* case,[6] wherein the Commission listed three types of automatic adjustment clauses which had previously been allowed without conditions: (1) fuel adjustment clauses, (2) full cost of service formula tariffs, particularly for unit sales and sales to affiliates, and (3) interchange rates based upon incremental costs. Staff views the MSS proposal in this proceeding as clearly coming within the purview of (2) above.

If the MSS formulae are not accepted as the rate for the entire period of the contract, the staff proposes that they be accepted as the rate subject to review of the entire formulae at the end of each three-year period of their operation, and an annual review of the proposed increases and decreases under the formulae. The staff's annual review proposal, set forth in detail on page 13 of the initial decision, is similar to the judge's proposal except that the review would be based on estimated rather than actual past data and would begin *prior* to the time the formulae rates become effective, as in a regular Section 205 proceeding. According to the

6/ Docket Nos. EL79-26 and ER79-600, order issued May 2, 1980.

staff, the judge's ruling attempts to review rates that have already been lawful for one year, and to make refunds at this point would be retroactive ratemaking.

The Commission finds that good cause has been shown to accept MSS' proposed formulae as the rate, [7] without any attached review conditions. As stated in *Central Power & Light Company, supra,* the Commission has previously allowed certain types of automatic adjustment clauses without conditions, including full cost of service tariffs for unit sales and sales to affiliates. We find acceptance of the formulae in the instant proceeding particularly appropriate because the proposed formulae provide for upward and downward adjustments in essentially all of MSS' costs, and because the sales involved are among affiliates operating on a pool basis. The costs which are distributed to the operating companies under the formulae will be subject to audit by the commission, as well as investigations which might be commenced under Section 206 of the Federal Power Act.

Rate of Return

Louisiana excepts to the judge's decision that the rate of return on common equity for the formulae should be the cost of equity of the operating companies' parent, MSU. MSS, the staff, and Louisiana except to the judge's decision

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7/ We noted in *Central Power & Light Co., supra,* that automatic adjustment clauses are exceptions to the notice and review provisions of the Federal Power Act and that in order to remove the changes in charges under an "automatic" clause from the notice, filing and suspension provisions of Section 205, the Commission must expressly approve the clause as the rate rather than merely accept the contract containing the clause. Mimeo, at 3 . The initial decision did not do this.

that MSU's cost of equity is 13.75 percent. Both MSS and the staff think the rate of return on common equity should be 14 percent, the return requested by MSS. Louisiana thinks the rate of return, based on MSU's cost of equity, should be between 10 and 13.5 percent. We agree with the judge that the rate of return on common equity for the formulae should be the MSU's cost of equity. But we agree with MSS and the staff that the rate of return should be fixed at 14 percent.

Four witnesses recommended equity returns shown on Table I:

Table I

Witness & Sponsor	*Derivation Methods*	*Recommended Range of Return on Common Equity*	*Recommended Rate of Return on Common Equity*
Langum (MSS)	Comparative Risk	14.9%–15.4% 13.4%–13.9%	14.5%*
Randall (Staff)	DCF** and Risk-premium	14.6%–15.3%	15.25%
Louiselle (Louisiana)	Weighted average of returns established in wholesale and retail rate cases of the operating companies.		12.5%
Lurito (Louisiana)	DCF	13.25%–13.8% (if sales were to	

unrelated, independent entities and there were a fixed tariff)
10.0%–13.5%
(if the cost of service feature of the System Agreement affected the stability and level of MSU earnings)

* Although the MSS witness recommended a 14.5 percent rate of return, MSS seeks only a 14 percent return in this proceeding. This is based on a capital structure ratio of 34 percent common equity, 56 percent debt and 10 percent preferred stock.

** Discount Cash Flow.

Louisiana's exceptions are not only to the percentage of return allowed by the judge, but also to the use of *any* traditional rate of return analysis. Louisiana contends that the traditional rate of return standards of the *Hope* and *Bluefield* cases [8] are irrelevant in this proceeding due to the nature of equalization payments. Louisiana bases its argument on three assumptions: (1) that the rate of return on equity embodied in the formulae cannot affect the earnings of the consolidated MSU system; (2) that the rate of return

8/ *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Waterworks and Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923).

allowance cannot affect the earnings of the individual operating companies, except during the period of regulatory lag; and (3) that the ability of the MSU system and its "selling" companies to attract capital generally cannot be affected by the cost of equity allowance in the formulae.

Under Louisiana's veiw, the sole consideration in setting the rate of return is the potential discriminatory effect the rate of return allowance may have on ratepayers in the subsidiaries' various jurisdictions. Louisiana claims that if the rate of return on equity is set at a level higher than the weighted average of the wholesale and retail rates of return allowed in the relevant jurisdictions, then ratepayers of "buying" companies will be required to advance revenues to MSU in excess of the cost of service in their jurisdictions, while ratepayers of "selling" companies will receive revenue credits that will reduce their own revenue requirement below the cost of service. The only allowance that minimizes this discrimination, says Louisiana, is the weighted average of 12.5 percent. According to Louisiana, the judge ignored the discrimination issue.

Louisiana further contends that the judge, in setting a rate of return, was in error in focusing on the entire electric operation of the company rather than considering the minimal risk to the "selling" companies operating under the formulae. The risk to the selling companies is virtually zero, alleges Louisiana, because: (1) the formulae are similar to a take or pay rates; (2) the rates are based on computations that include the marginal investment and fixed charge capital costs of the selling companies; and (3) the selling companies avoid the risk of attrition and regulatory lag because all costs except cost of equity are recovered through automatic adjustment clauses.

The Commission does not agree with all of the premises underlying Louisiana's argument that the traditional *Hope* and *Bluefield* standards are irrelevant here. The parties concur that the rate of return on equity cannot affect the earnings of the *consolidated* MSU system since for every dollar received by a "selling" company, there will be a corresponding expense incurred by the "buying" company. However, all parties do not agree with, and the evidence does not support, Louisiana's contention that receipts and payments for pool transactions do not affect the individual operating companies.

All common stock in the MSU subsidiaries is owned by MSU, but each operating company must maintain its own credit worthiness since all long-term financing is done by the individual companies. [9] When the individual subsidiary attempts to sell new bonds and preferred stock to the public, it is evaluated by rate agencies and market investors based not only on its own capital structure and financial status but also on system matters that bear on the company. [10] This is exemplified by the fact that the bond ratings of Mississippi Power & Light Company were recently downgraded partially due to the overall financial deterioration within the MSU system. [11] We cannot conclude that the

9/ Exh. 9 at 4.

10/ Tr. 233.

11/ Exh. 6 at 5. Standard & Poor's Corp. (S&P) downgraded MP&L's outstanding first mortgage bonds from A to BBB and its outstanding preferred stock from A to BBB. S&P stated in part, "The more pressing capital needs of other system companies would appear to require prior claim on the parent company's financial resources, *particularly common equity.*" (Source: Standard & Poor's Corp., *Fixed Income Investor*, March 8, 1980, p. 938).

rates each subsidiary must pay to obtain needed capital through the sale of bonds and preferred stock will not be affected by the MSU return on common equity. To the extent that the rate of return allowed by this Commission does not reflect MSU's actual cost of equity and does not provide adequate financial security to the bond and preferred stockholders, the returns required by them will increase. Likewise, if Louisiana's proposed weighted average is used, the action of one or more state commissions in setting rates based on a rate of return less than its subsidiary's actual cost of equity will result in a higher overall cost of capital and an offsetting cost increase in the overall cost of equity or in the cost of capitalization through bonds or preferred stock. This can have an effect on ratepayers served by other operating subsidiaries or conceivably on MSU equity financing.

In reference to Louisiana's argument that the rate of return cannot affect the earnings of the individual companies, this would be true only if there were instantaneous regulatory response by the state and federal regulatory commissions to the various pool transactions. We do not think the problem of regulatory lag can be ignored since, as the record shows, a minimum of 18 rate decisions would have been required to maintain a reasonably constant rate of return for each of the operating subsidiaries for the 12-month period ending March 1980.[12]

We agree with Louisiana that this Commission, in determining just and reasonable rates, also has an obligation to consider the potential discriminatory impact of those rates

12/ Exh. 9 at 7. MSS witness Leo also testified on cross-examination that there were some 31 changes in capacity sales in the course of a year. Tr. 274.

on non-jurisdictional customers.[13] However, based on the evidence and arguments presented, we cannot conclude that Louisiana's weighted average theory will necessarily eliminate or minimize discrimination. To eliminate discrimination would require not only that the rates of return for all companies be the same, but that identical regulatory treatment be accorded the companies as to all other rate elements. We agree with the judge that averaging various returns on equity established at different times in different jurisdictions which use different policies, standards and methodologies in setting rates is not the proper way for this Commission to establish a just and reasonable wholesale rate. While some rate discrimination is inherent in the MSU tariff, in theory the "short" companies will become "long"[14] and vice versa over time such that in the long run, any discriminatory effects will cancel each other out and the result will be economies of scale which ultimately benefit all customers of the five subsidiaries.

We also cannot accept Louisiana's contention that the judge erred in focusing on the entire electric operations of MSU. Investors in MSU purchase equity in the entire holding company, not just in the selling companies or in the buying companies[15] Therefore, we do not think it appropriate to consider only the so-called minimal risk to selling companies in establishing a proper rate of return. As pointed out by the judge, this decision is in accord with recent Commission

13/ *F.P.C. v. Conway Corp.*, 426 U.S. 271, 277-279 (1976).

14/ "Short" companies refers to operating companies which purchase generating capacity or transmission from "long" companies having excess capacity or transmission under the System Agreement.

15/ See *Louisiana Power & Light Co.*, Opinion No. 104, Docket No. ER77-533 (Phase II)(December 16, 1980), slip op. at 9.

opinions.[16]

The exceptions of MSS and the Commission staff are to the percentage of return allowed and the judge's criticisms of their individual rate of return studies. We do not find it necessary to more specifically address the arguments of MSS because the rate of return approved herein is that sought by MSS and because we basically agree with the judge's finding that MSS' rate of return study does not present a sufficient basis for establishing the proper rate of return. The staff's exception to the judge's criticism of its DCF rate of return study is a different matter.[17] The staff witness performed a DCF analysis of MSU. In determining the growth rate the witness examined historical growth rates and extrapolated future growth rates from the data. The witness also estimated

16/ *Missouri Utilities Co.*, Opinion No. 82, Docket Nos. ER77-354 and ER78-14 (March 28, 1980), wherein we affirmed the focus of the rate of return risk analysis on the entire electric operations of a multiple service corporation; *Otter Tail Power Co.*, Opinion No. 93, Docket Nos. ER77-5 and E-8152 (August 15, 1980), wherein we geared the equity return to the company's business as a whole and stated a policy against unbundling of the various functions of the electric business of a utility and apportioning equity return commensurate with the risk of each function; *American Electric Power Service Corp.*, Opinion No. 50, Docket No. E-9408 (July 27, 1979), wherein we made an independent assessment of the cost of equity and established a single rate of return for an interconnection agreement among four subsidiary operating companies of AEP.

17/ The staff witness also presented a risk premium analysis. The risk premium used came from a survey performed by a brokerage house of an unidentified number of institutional investors. The survey is not in the record and has not been shown to have any statistical validity. Accordingly, we affirm the judge's holding that the staff witness' risk premium analysis is entitled to little weight.

future growth rates.[18] The staff witness' judgment was that MSU's historical growth rate could not be maintained in the future.[19] He therefore used his estimated growth rate in determining MSU's cost of equity. The cost of equity the staff witness derived from his DCF analysis was 15.33 percent.

No party criticized the staff witness' estimate of MSU's future growth rate. And the judge found no problem with that estimate. Nevertheless, the judge gave little or no weight to the witness' DCF study. The judge did so solely because the witness had used an estimate. That is not a legitimate criticism of the witness's DCF analysis. We have encouraged DCF analysis because we are interested in forward-looking analysis of rate of return.[20] That presupposes that a witness sponsoring a DCF analysis will consider future growth rates. In doing so the witness may rely solely on extrapolations of past growth rates where those growth rates are expected to continue.[21] But where, as here, past growth rates are not expected to continue the witness may properly estimate future growth rates. Indeed, we have encouraged witnesses to provide "thoughtful, and well-supported, estimates of the growth rate factor."[22] In holding otherwise

18/ Exh. 14, pp. 22-25, 26-27.

19/ *Id.*, at 27.

20/ *Minnesota Power & Light Company*, Opinion No. 12, Docket No. E-8494 (April 14, 1978), slip op. at 11.

21/ *Central Illinois Light Company*, Opinion No. 81, Docket No. ER76-819 (March 20, 1980), slip op. at 21 note 41.

22/ *Id.*, at 21.

the judge erred.

Because the staff witness' estimates of MSU's future growth rates are "thoughtful" and "well-supported" (indeed, they have not been criticized by any party), we find that the staff witness' DCF analysis is entitled to considerable weight. Moreover, because, as the judge found, the other rate of return studies presented are fatally flawed, we find on the basis of the staff witness' DCF analysis that the 14 percent rate of return on common equity requested by MSS is supported by the weight of the record evidence.[23]

Capital Structure Ratios

MSS excepts to the judge's decision that MSU's capital structure ratios should be updated such that current capitalization ratios are used in the cost of service formulae and are changed as MSU's actual capitalization ratios change. MSS claims that the ratios which have been used since 1974 are reflective of financial planning objectives and are those which the operating companies strive to achieve and maintain. It further contends that updating is inconsistent with the establishment of a fixed equity return component.

MSS has not provided sufficient reason to continue using hypothetical "target" ratios which do not reflect its actual capitalization. As shown by Exhibit 20, the actual consolidated capital structure of MSU as of December 31, 1979, was 33.02 percent common equity, 53.39 percent debt and

23/ MSS does not request a rate of return higher than 14 percent. Should MSS determine that because of changed circumstances a 14 percent rate of return is no longer adequate, it is free to make a new filing. *Hampshire Gas Company*, Docket No. RP75-97 (March 21, 1979), *mimeo* at 18-19.

13.59 percent preferred stock. This is in contrast to MSS's fixed hypothetical capital structure of 34 percent common equity, 56 percent debt and 10 percent preferred stock.

We affirm the judge's conclusion that Commission precedent supports the use of the latest available evidence of a company's capital structure. As MSU's actual capitalization ratios change, they should be reflected in the cost of service formulae approved herein.

Accumulated Deferred Taxes

Louisiana excepts to the judge's conclusion that it waived its right to present argument on the issue of accumulated deferred taxes that become available through the use of accelerated depreciation for tax purposes, and that these sums should be eliminated from the investment used to compute the rate because they are consumer supplied.

Although we affirm the judge's ruling on the waiver issue, we find it appropriate to raise the issue on our own motion and to direct MSS to remove accumulated deferred taxes from rate base. Section 2.12 of our regulations states the Commission's policy to deduct from rate base balances in Account 282 of the Uniform System of Accounts, "Accumulated deferred income taxes–Other property." This general policy is also reflected in Opinion No. 12[24] and Order No. 144.[25] We find it essential that proper cost of

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24/ Supra note —.

25/ Final Rule Requiring Tax Normalization and Order Removing Refund Contingencies, Docket Nos. RM80-42, R-424 and R-446 (May 6, 1981), at 60-61.

service elements be reflected in the rates approved here since we are approving formula rates which are not subject to any review conditions.

The Commission orders:

(A) The initial decision issued in this docket on November 13, 1980, is affirmed and adopted to the extent not modified herein.

(B) Any exceptions to the initial decision not granted herein are denied.

(C) The rates filed by MSS, which are in effect in this docket subject to refund, are disallowed to the extent they do not conform to this order.

(D) Within 90 days after the date of issuance of this order, MSS shall file any necessary amendments to the System Agreement and service schedules thereunder to the extent they do not conform with the findings and conclusions of this order.

(E) Within 90 days after the date of issuance of this order, the operating subsidiaries of Middle South Utilities, Inc., shall refund to their customers any amounts collected in excess of those amounts which would have been payable under the rates and charges approved in accordance with Ordering Paragraph (D), above, together with interest at the rates established by the Commission, from the date of payment to the date of refund.

(F) The motion for oral argument filed in this docket on February 3, 1981, by the Louisiana Public Service Commission is denied.

Commissioner Holden voted present.

APPENDIX II

LOUISIANA PUBLIC SERVICE
COMMISSION, Petitioner,

v.

FEDERAL ENERGY REGULATORY
COMMISSION, Respondent.

No. 81-4470

United States Court of Appeals,
Fifth Circuit

Oct. 4, 1982

Federal Energy Regulatory Commission expanded categories of expenses subject to automatic adjustment formula and interest rate of return on common equity allowed under agreement for interstate sales of power among affiliated electric utilities, and state Public Service Commission sought judicial review. The Court of Appeals, Johnson, Circuit Judge, held that: (1) Commission's decision to utilize automatic adjustment clause was not invalid; (2) good cause was demonstrated to support exception to general notice requirement of Federal Power Act; (3) rate of return on common equity at 14% complied with statutory requisites; and (4) Commission did not err in focusing on electric operations of entire system in setting rate of return.

Affirmed.

1. Public Utilities key 195

Litigant seeking to overturn rate decision of Federal Energy Regulatory Commission must make convincing

showing that it is invalid because it is unjust and unreasonable under the circumstances. Federal Power Act, §205(a) as amended 16 U.S. C.A. §824d(a).

2. Public Utilities key 194

In reviewing decision by Federal Energy Regulatory Commission, Court of Appeals is without authority to set aside any rate selected by Commission which is within "zone of reasonableness." Federal Power Act, §205(a) as amended 16 U.S.C.A. §824d(a).

3. Public Utilities key 122

Federal Energy Regulatory Commission is not bound to single rate-making method or formula, but is free to make pragmatic adjustments in its methods.

4. Public Utilities key 194

In reviewing facts relied upon by Federal Energy Regulatory Commission in reaching its decision, Court of Appeals must only decide whether facts relied upon by Commission are supported by substantial evidence. Federal Power Act, §313(b) as amended 16 U.S.C.A. §825l(b).

5. Electricity key 11.3(1)

Decision by Federal Energy Regulatory Commission to utilize automatic adjustment clause in setting rates for interstate sales of power among affiliated electric utilities was not invalid. Federal Power Act, §205(a, f) as amended 16 U.S.C.A. §824d(a,f).

6. Electricity key 11.3(4)

Good cause existed to allow deviation from general notice provisions of Federal Power Act so as to allow expansion of category of expenses subject to previously approved automatic adjustment formula used in determining rates for interstate sales of power among affiliated electric utilities. Federal Power Act, §205 as amended 16 U.S.C.A. §824d.

7. Electricity key 11.3(5)

Rate of return on common equity at 14% for affiliated electric utilities among which interstate sales of power occurred complied with statutory requisites where such rate of return did not reach unreasonable and unjust results, did not unduly discriminate against ratepayers and was supported by substantial evidence.

8. Electricity key 11.3(5)

Where investors in affiliated electric utilities among which interstate sales of power occurred purchased equity in entire holding company, not merely in "selling" companies or "buying" companies, Federal Energy Regulatory Commission did not err in focusing on electric operations of entire system in setting rate of return on common equity. Federal Power Act, §205(b) as amended 16 U.S.C.A. §824d(b).

Michael R. Fontham, Paul L. Zimmering, New Orleans, La., Marshall B. Brinkley, Gen. Counsel, Louisiana Public Service Com'n, Baton Rouge, La., for petitioner.

Norma Rosner, F. E. R. C., Washington, D. C., for respondent.

Richard M. Merriman, Robert S. Waters, Washington, D. C., for Middle South Services, Inc.

Petition for Review of an Order of the Federal Energy Regulatory Commission.

Before CLARK, GARZA, and JOHNSON, Circuit Judges.

JOHNSON, Circuit Judge:

Petitioner, the Louisiana, Public Service Commission (Louisiana Commission), seeks review of a decision of the respondent, the Federal Energy Regulatory Commission (FERC), involving the rates set by FERC for interstate sales of power among four affiliated electric utilities. The four affiliated electric utilities, collectively known as the Middle South Utilities System (MSU), sought expansion of the categories of expenses subject to a previously approved automatic adjustment formula and an increase in the rate of return allowed under the MSU system agreement (Agreement). The order of FERC, which affirmed in part and modified in part the decision of the administrative law judge, expanded the categories of expenses subject to the automatic adjustment formula and increased the rate of return allowed under the Agreement. Having concluded that FERC's decision is supported by substantial evidence and results in a just and reasonable rate that does not unduly discriminate against ratepayers, this Court affirms.

I. *The Middle South Utilities System and Its Operation:*

MSU is composed of Middle South Utilities, Inc., a public

utility holding company, Middle South Services, Inc. its subsidiary-agent for regulatory matters, and four electric utility subsidiaries: Louisiana Power and Light Co., Arkansas Power and Light Co., Mississippi Power and Light Co. and New Orleans Public Service, Inc. The Agreement, approved as the operating tariff by FERC in 1973, composes the contractual framework for the interchange of power among the four affiliated electric utilities. 49 FPC 1472 (June 29, 1973). Section 3.01 of the Agreement provides that the purposes of the Agreement are:

> . . . to provide the contractual basis for the continued planning, construction, and operation of the electric generation, transmission and other facilities . . . and to provide a basis for equalizing among the Companies any imbalance of costs associated with the construction, ownership and operation of such facilities as are used for the mutual benefit of all the Companies.

Charges under the Agreement are made under five separate service schedules: (1) capability equalization, (2) transmission equalization, (3) exchange of electric energy, (4) distribution of revenue from sales made for the joint account of all the companies, and (5) distribution of operating expenses of the system operations center. The issues in this appeal revolve around capability and transmission equalization service schedules.

The Agreement requires each of the affiliated utility companies to maintain the generating capacity and other facilities necessary to supply its own local requirements. However, in order to achieve economies of scale through the construction of large units, an individual utility may be required to construct, own, and operate a new generating unit of sufficient size to help provide the power necessary

to obtain the operating requirements of the entire MSU system. A utility that has a generating capacity less than its respective responsibility (a "short" or "buying" company) is required to pay a capability equalization charge to utilities generating, or capable of generating, power in excess of their respective responsibilities ("long" or "selling" companies).

Although the service schedules at issue in this proceeding govern the amounts paid and received among operating companies as a result of system-wide transactions, the same payments and receipts are accounted for in wholesale and retail regulatory proceedings in the respective states of each utility. In other words, the amounts received by a "selling" company may be utilized as income in determining the rates that ratepayers in the "selling" company's territory must pay in order to achieve the rate of return permitted in that particular territory. Likewise, payments made by a "buying" company may be considered expenses in determining the rates that ratepayers in the "buying" company's territory must pay in order to achieve the rate of return permitted in that particular territory. Consequently, the amounts charged ratepayers of different territories are dependent upon the status of the utility operating in each territory.

Under the previously approved operating tariff, operation and maintenance costs, general administrative over-heads attributable to the production function, return on common equity, and the structure ratios were fixed, but, the other components were adjusted automatically as their values increased or decreased. MSU, through its subsidiary-agent, Middle South Services, Inc., sought to place operation, maintenance, and general and administrative expenses under the automatic adjustment formula, thereby making all costs, except cost of equity, subject to the automatic adjustment

formula. FERC granted MSU the requested changes in the automatic adjustment formula, and, furthermore, increased the rate of return on common equity to 14%. Louisiana Commission has perfected this appeal complaining of FERC's decision as to the appropriate expenses subject to the automatic adjustment formula and the proper return on common equity.

II. *The Standard of Review:*

[1-4] A litigant seeking to overturn a rate decision of FERC must make a "convincing showing that it is invalid because it is unjust and unreasonable under the circumstances." *FPC v. Hope Natural Gas Company*, 320 U.S. 591, 64 S.Ct. 281, 288, 88 L.Ed. 333 (1944); *United Gas Pipe Line v. FERC*, 618 F.2d 1127, 1131 (5th Cir. 1980). In reviewing a decision by FERC, this Court is "without authority to set aside any rate selected by the Commission which is within a 'zone of reasonableness' ". *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 1360, 20 L.Ed.2d 312 (1968) (quoting *FPC v. Natural Gas Pipeline Company*, 315 U.S. 575, 62 S.Ct. 736, 743, 86 L.Ed. 1037 (1942). Additionally, FERC is not "bound to a single rate making method or formula, but is free to make pragmatic adjustments in it's methods." *Arkansas, Louisiana Gas Co. v. FERC*, 654 F.2d 435 (5th Cir. 1981). Moreover, in reviewing the facts relied upon by FERC in reaching its decision, this Court must only decide whether the facts relied upon by FERC are supported by substantial evidence. 16 U.S.C. §825(b) (1976); *In re Permian Basin Area Rate Cases*, 88 S.Ct. at 1372.

III. *Automatic Adjustment Clauses:*

[5] 16 U.S.C. §824d(a) requires FERC to review public

electric utility rates for reasonableness. However, §824d(f) authorizes the use of an automatic adjustment clause in the computation of utility rates when the use of such a clause would result in the "efficient use of resources" and the "economical purchase and use of fuel, electric energy, and other items." 16 U.S.C. §824d(f) (1976). Additionally, FERC is required to review periodically the use of such clauses for efficiency and to determine:

> whether any such clause reflects any costs other than costs which are—
> (i) subject to periodic fluctuations and
> (ii) not susceptible to precise determinations in rate cases prior to the time such costs are incurred.

16 U.S.C. §824d(f)(1)(B). Although the statute specifies criteria to be used by FERC in reviewing the use of automatic adjustment clauses, the statute does not state that the use of such clauses is restricted to unstable, unpredictable expenses. In fact, in 1978 Congress specifically recognized FERC's practice of authorizing an automatic adjustment formula to operate as a rate. Under §208 of the Public Utility Regulatory Policies Act of 1978 (PURPA), FERC is required to review the use of automatic adjustment clauses. Public Utility Regulatory Policies Act of 1978, Pub.L.No. 95-617, 92 Stat. 3117 *et seq.* (1978). Significantly, however, the Conference Report accompanying PURPA states that "the conferees do not indicate any preference for inclusion or exclusion of any item in an automatic adjustment clause." H.R.Rep. No. 95-1750, 95th Cong. 2d Sess. 96 (1978) U.S. Code Cong. & Admin. News 1978, pp. 7659, 7830. Therefore, this Court, recognizing that FERC's order is "the product of expert judgment which carries a presumption of validity. . . .," holds that FERC's decision to utilize

the automatic adjustment clause in the instant case is not invalid. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 288, 88 L.Ed. 333 (1944); *United Gas Pipe Line v. FERC*, 618 F.2d 1127 (5th Cir. 1980), cert. denied, 450 U.S. 911, 101 S.Ct. 1349, 67 L.Ed.2d 335 (1981). However, our inquiry does not end here.

[6] 16 U.S.C. §824d provides that:

> Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, except after sixty days notice to the Commission and to the public. The Commission, for good cause shown, may allow changes to take effect without requiring the sixty days' notice herein provided for by any order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

16 U.S.C. §824d (Supp. 1982). Louisiana Commission contends that FERC erred in finding good cause to extend the scope of expenses computed under the automatic adjustment clauses. In response, FERC maintains that its decision to extend the scope of expenses allowed under an automatic adjustment clause is supported by the decision in *Central Power and Light Co.*, 11 FERC ¶61,101 (1980), wherein FERC noted its decision to allow the use of automatic adjustment clauses, without conditions, in full cost of service tariffs for unit sales and sales to affiliates. This Court affirms FERC's decision that good cause has been demonstrated to support an exception to the general notice requirement of §824d. 16 U.S.C. §824d (Supp. 1982).

As FERC noted in its decision, the use of automatic adjustment clauses in the instant proceeding is "particularly appropriate because the proposed formula provide[s] for upward and downward adjustments . . . and because the sales involved are among affiliates operating on a pool basis." *Middle South Services, Inc.*, FERC Opinion No. 124 at 5. Moreover, as FERC contends, under the automatic adjustment clause formula, ratepayers can be assured that they will be required to pay only for actual increases and decreases in cost. This is true because the automatic adjustment formula itself, rather than an estimated unit charge, constitutes the rate. It should be noted that the accuracy of the costs included under the formula could be verified by FERC audit, or by an investigation instituted under §206 of the FPA. Therefore, this Court concludes that FERC's decision that good cause exists to allow deviation from the general notice provisions of §824d is supported by substantial evidence. *See* 16 U.S.C. §8251(b)(1976); and *In re Permian Basin Area Rate Cases*, 88 S.Ct. at 1372.

IV. *Rate of Return:*

[7] Louisiana Commission argues that FERC's decision to set the rate of return on common equity at 14 percent is erroneous. It maintains that FERC erred in utilizing the traditional cost of analysis in arriving at the appropriate rate of return due to the unique nature of the interaffiliate transactions that take place under the Agreement. *See FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Bluefield Water Works and Improvement Co. v. Public Service Commission*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923). This Court holds that the result reached by utilization of FERC's method of arriving at the proper rate of return is not unjust and unreasonable, and, therefore, affirms FERC's decision to set the rate

of return for MSU at 14%.

In reviewing a rate of return set for a utility by FERC, this Court must determine whether the rate set is "just and reasonable." 16 U.S.C. §824d(b). At the same time, §824d (b) prohibits a utility from granting any "undue preference or advantage to any person," subjecting anyone to "an undue prejudice or disadvantage," or maintaining any "unreasonable difference in rates [or] charges. . . between classes of service." 16U.S.C. 824d(b). However, it should be noted that it is the *result* of the rate that must comply with these statutory requirements, not the *method* employed in arriving at the contested rate. *Los Angeles Gas & Electric Corp. v. Railroad Commission*, 289 U.S. 287, 53 S.Ct. 637, 643, 647, 77 L.Ed. 1180 (1933); *West Ohio Gas Company v. Public Utility Commission*, 294 U.S. 63, 55 S.Ct. 316, 320, 79 L.Ed. 761 (1935); and *Arkansas, Louisiana Gas Co. v. FERC*, 654 F.2d at 437.

Louisiana Commission argues strenuously that the discriminatory impact upon ratepayers caused by FERC's method of establishing the rate of return demonstrates the unreasonableness and unjustness of the rate of return set for MSU. Commendably, MSU's system seeks to operate its interaffiliated affairs in a manner that will save money for ratepayers of the operating companies by maximizing efficiency and reducing costs. Admittedly, the system results in rate differences in the various jurisdictions occasioned by the natural operation of multiple regulatory systems. For example, the ratepayers in a "buying" company's territory may be required to pay higher rates so that the "buying" company can achieve the maximum return of common equity allowed by FERC. However, as FERC noted in its decision, "in theory the 'short' companies will become 'long' and vice versa over time so that, in the long run, any

discriminatory effects will cancel each other out and the result will be economies of scale which ultimately benefit all customers of the five subsidiaries." *Middle South Services, Inc.*, FERC Opinion No. 124 at 9-10. Moreover FERC concluded that Louisiana Commission's weighted average theory would not necessarily eliminate or minimize discrimination. FERC noted that "[t]o eliminate discrimination would require not only that the rates of return for all companies be the same, but that identical regulatory treatment be accorded the companies as to all other rate elements." *Middle South Services, Inc.*, FERC Opinion No. 124 at 9. In light of FERC's conclusions, which this Court determines are supported by substantial evidence, the Court concludes that the rate of return complies with the statutory requisites.

[8] Louisiana Commission also contends that FERC erred in approving the administrative law judge's decision to focus on the entire electric operations of MSU in setting the rate of return. However, investors in MSU purchase equity in the *entire* holding company, not just in the "selling" companies or "buying" companies. Once again, although rate discrepancies may exist from time to time in the various territories, in the long run "short" companies will become "long" companies and vice versa. Hence, FERC did not err in focusing on the entire electric operations of MSU in setting the rate of return. *See Cities of Aitken v. FERC*, No. 80-2375 (D.C.Cir. March 5, 1982).

Having concluded that the rate of return does not reach unreasonable and unjust results, does not unduly discriminate against ratepayers, and is supported by substantial evidence, this Court affirms FERC's approval of a 14% rate of return.

V. *Conclusion:*

In summary, this Court holds that FERC did not err in approving the extension of expenses allowed under the automatic adjustment clause utilized by the Middle South Utility System. Also, this Court concludes that FERC did not err in approving a 14% rate of return on common equity. Therefore, the decision of FERC is affirmed.

AFFIRMED.

APPENDIX III

STATUTORY PROVISIONS

16 U.S.C. §824d(b):

(d) Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after sixty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the sixty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

16 U.S.C. §824d(f):

(f) (1) Not later than 2 years after November 9, 1978, and not less often than every 4 years thereafter, the Commission shall make a thorough review of automatic adjustment clauses in public utility rate schedules to examine—

> (A) Whether or not each such clause effectively provides incentives for efficient use of resources (including economical purchase and use of fuel and electric energy), and

(B) Whether any such clause reflects any costs other than costs which are—

(i) subject to periodic fluctuations and

(ii) not susceptible to precise determinations in rate cases prior to the time such costs are incurred.

Such review may take place in individual state proceedings or in generic or other separate proceedings applicable to one or more utilities.

(2) Not less frequently than every 2 years, in rate proceedings or in generic or other separate proceedings, the Commission shall review, with respect to each public utility, practices under any automatic adjustment clauses of such utility to insure efficient use of resources (including economical purchase and use of fuel and electric energy) under such clauses.

(3) The Commission may, on its own motion or upon complaint, after an opportunity for an evidentiary hearing, order a public utility to—

(A) modify the terms and provisions of any automatic adjustment clause, or

(B) cease any practice in connection with the clause,

if such clause or practice does not result in the economical purchase and use of fuel, electric energy, or other items, the cost of which is included in any rate schedule under an automatic adjustment clause.

(4) As used in this subsection, the term "automatic adjustment clause" means a provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include any rate which takes effect subject to refund and subject to a later determination of the appropriate amount of such rate.